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FY 1988 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

Since early 1985 the yen has more than doubled in value. As expected it has led to fewer exports, more imports and increased purchasing power for Japanese consumers, although all these effects have come more slowly than anticipated.

In the past the Japanese economy has often grown in the face of declining demand from abroad, but this time the yen's appreciation came after several years of booming exports and the adjustment was expected to be difficult. While far from painless, the process has been less traumatic than many expected. In fiscal year 1987, which ends March 31, 1988, inflation-adjusted growth may well reach 4 percent, exceeding the government's 3.7 percent estimate issued only two months ago.

The continued appreciation of the yen in November and December suggests the adjustment process will continue into FY 1988, with rising domestic demand again offsetting declining net exports. Inflation will remain low, reflecting in part the yen's continued strength.

The Economy in FY 1987

A year ago Japanese policymakers and industrial leaders were fairly pessimistic. During FY 1986 the yen had appreciated against the dollar by 38.3 percent. While exports had fallen some in volume, there was a strong sense that much of the adjustment was still to come. Domestic demand was expected to increase during the April 1987-March 1988 period but falling net exports would

bring the growth rate down significantly. The government estimated that the external component would contribute -0.5 percent and the domestic component 4 percent to the expected real growth rate of 3.5 percent, assuming an exchange rate of 163 yen to the dollar. Private forecasters on average were not nearly as optimistic, predicting only a 2.4 percent increase in inflation-adjusted gross national product (see JEI Report No. 6A, February 13, 1987) with the yen at 150 to 170 to the dollar.

The government's revised estimate for the 1987 fiscal year reflects the unexpected changes that have occurred in currency markets. The yen is now expected to average Y140=$1.00 for the April 1987-March 1988 period, or close to the figure for the first 10 months of the fiscal year. Since the yen has appreciated so much, the external sector's drag on the economy is correspondingly greater, now put at -1.3 percent (see Table 1). In spite of this, the projected real growth rate is 3.7 percent, up 0.2 percentage point from the original outlook, as a result of stronger than expected domestic demand, which is expected to grow by 5 percent through March 31.

Table 1: Components of Japan's Real Economic Growth

		Domestic		External
	Total	Private	Public	Component
FY 1981	3.3%	1.5%	0.5%	1.2%
FY 1982	3.2	2.6	0.1	0.5
FY 1983	3.7	1.9	0.2	1.5
FY 1984	5.1	3.7	0.2	1.3
FY 1985	4.4	4.0	-0.3	0.8
FY 1986	2.6	2.8	1.3	-1.5
FY 1987*	3.7	4.4	0.6	-1.3
FY 1988**	3.8	4.5	0.3	-1.0

*Calculated from government growth estimate.
**Calculated from government outlook.

Source: Economic Planning Agency

The FY 1987 results have been affected by a number of important developments. In February, two months after the government released its forecast, the Group of Seven industrial nations met in France and ironed out what became known as the Louvre Accord, essentially committing the participants to maintain exchange rates at close to existing levels. Although at first the agreement appeared to be working, it may have contributed to the unsettled conditions in the fall when global equity markets dropped dramatically and the yen resumed its rapid ascent. In any case, the unprecedented stock market crash left analysts wondering about the long-term impact, especially on American consumer and corporate spending plans.

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As part of the Louvre Accord, Japan took major steps to expand its economy. The discount rate was lowered in February to an all-time-low 2.5 percent and has stayed there. Other interest rates, helped by a continuing expansionary monetary policy, followed it down. The government began implementing a Y6 trillion ($48 billion at Y125=$1.00) supplemental fiscal stimulus package that emphasized public works but also included an estimated Y1.5 trillion ($12 billion) in personal income tax cuts. These monetary and fiscal measures contributed to an expansion of domestic demand that more than offset the decline in the external sector.

The trade imbalances of the United States and Japan continue to dominate discussions among major trading countries. Both the surplus in Japan and the deficit in the United States are seen as unresponsive to exchange rate changes or other policy measures. In fact, the FY 1987 outlook for the Japanese economy underestimated the drop in the current account surplus. Originally projected at Y12.5 trillion, the government now sees a surplus of Y11.5 trillion.

The Prospects for FY 1988

Each December the Japanese cabinet drafts an economic outlook for the coming fiscal year that becomes part of the budget process. In broad terms the FY 1988 outlook projects a continuation of current trends (see Tables 2-4). The government expects inflation-adjusted growth to accelerate to 3.8 percent from FY 1987's 3.7 percent target, even though it is planning to limit the expansion in public-sector spending to 1.7 percent, well below the 3.5 percent pace for the current year when the supplemental budget amount is added. Moreover, the external sector will be a drag on growth for the third straight year.

In FY 1986 and FY 1987, the yen appreciated more than forecast in the outlook. In fiscal 1986 the assumption was Y204=$1.00 and the actual rate was Y160=$1.00. This made 4 percent real growth unobtainable; the government had to be content with 2.6 percent. In FY 1987, as noted above, a substantial supplemental budget triggered greater domestic demand to offset weaker than expected exports.

The same outcome is possible this year. Forecasts of the yen-dollar exchange rate vary widely. Some economists, taking heart from the dollar's direction in January and February, even expect the dollar to strengthen over the next few months. It is more likely, though, that it will have to decline further to reduce the U.S. trade deficit significantly. If the president elected in November is seen as credible in attacking this country's budget deficit, the dollar might drop; smaller budget deficits reduce the demand for foreign capital flows, which in turn slows the the number of foreign investors wanting to exchange their currency for dollars.

If the dollar does resume its decline, Japan will experience lower growth or will be forced to implement a more expansionary domestic policy. The government is again counting on private domestic demand to carry most of the load. Success, even in the absence of further upheavals in the currency markets, is far from guaranteed.

Table 2: Government's FY 1988 Economic Outlook

(percent change)

	Actual		Estimated		Projected
	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Real Gross National Product	5.1%	4.4%	2.6%	3.7%	3.8%
Consumer Spending	2.6	2.8	3.6	3.6	3.8
Residential Construction	0.5	2.9	10.9	16.5	1.9
Private Capital Spending	11.5	13.2	4.5	7.1	9.8
Government Spending	0.8	-1.7	7.8	3.5	1.7

Source: Economic Planning Agency

Table 3: Nominal Gross National Product

(in trillions of yen)

	Actual		Estimated		Projected
	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Gross National Product	Y303.0	Y321.2	Y334.7	Y348.4	Y365.2
Consumer Spending	178.1	186.5	193.1	201.2	211.5
Residential Construction	14.2	14.8	16.2	19.4	20.0
Private Capital Spending	47.1	52.8	53.8	56.4	62.0
Private Inventories	1.3	1.8	0.5	0.8	1.4
Government Spending	52.9	52.8	55.7	58.9	60.2
Net External Sector	9.4	12.5	15.4	11.8	10.3

Source: Economic Planning Agency

Table 4: Other Indicators

(percent change from previous year unless otherwise indicated)

	Actual		Estimated		Projected
	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Industrial Production	9.9%	3.4%	-0.5%	6.6%	7.6%
Wholesale Prices	0.4	-3.3	-9.4	-1.7	0.3
Consumer Prices	2.2	1.9	0.0	0.7	1.3
Unemployment (in thousands)	1,590	1,580	1,710	1,700	1,650

Source: Economic Planning Agency

Private-sector forecasters agree with the government's upbeat outlook (see Table 5). They were generally far less optimistic about prospects for FY 1987 and hence even further off the mark than government economists. Their original average prediction of 2.4 percent real growth will fall short of the economy's actual performance by at least 1 percentage point; in fact all 25 private-sector forecasts summarized a year ago now appear to have been too pessimistic even though they all underestimated the appreciation of the yen. For FY 1988 they anticipate real growth of 3.6 percent and an average exchange rate of Y129=$1.00, close to its recent value. The Research Institute of the National Economy, the most optimistic -- and the most accurate -- forecaster of FY 1987 developments is equally upbeat about the coming fiscal year, predicting real growth of 4.3 percent.

A few respected individual economists have dramatically different views. Hisao Kanamori, head of the prestigious Japan Economic Research Center, estimates 5.5 percent real GNP growth based on the benefits of the appreciated yen and increasingly broad-based consumption growth. Johsen Takahashi, senior economist at the Mitsubishi Research Institute, is more pessimistic than his institute, seeing only 2 percent inflation-adjusted growth based on such demand-dampening developments as the appreciation of the yen to as high as Y100=$1.00.

Generally, the close bunching of government and private-sector opinions would seem to warrant confidence in the figures, but that would be a mistake. As shown in Table 5, relatively little change in oil prices or exchange rates is expected, in many cases probably reflecting a belief that the possibility of significant change upward or downward is equally likely. Put another way, there is a good chance that the economy's performance will either be much worse or much better than the figures in the table suggest. With that caveat in mind, the stage is set for real growth of around 3 percent, somewhat lower than the consensus.

External Demand - With Japan the largest exporter of goods to the United States, it would not be surprising if Americans thought the Japanese economy was dependent on the United States. It is true that this country is by far Japan's largest trading partner, taking about 37 percent of its exports in 1987, down slightly from 39 percent in 1986. While expanding net exports to the United States and elsewhere help Japanese growth, they have not always been necessary. From FY 1970 to FY 1987, Japan's economy grew every year except FY 1974, even though net exports declined six times, including FY 1986 and FY 1987.

U.S. demand for imports is important, of course. In its economic outlook published in December 1987, the Organization for Economic Cooperation and Development estimated the effect on Japan of a further 15 percent depreciation of the dollar against the yen and other currencies except the Canadian dollar. If the depreciation occurred at the start of the year, it would reduce Japanese economic growth by 0.2 to 0.3 percentage point depending on the actions of the world's central banks. In addition, Japan is affected by the rate of growth in the U.S. economy: a recession would decrease demand for Japanese exports and reduce its growth rate.

Table 5: Summary of Private Forecasts, FY 1988

(percent change in real terms unless otherwise indicated)

	GNP		Current	Y/$	
	Revised FY 1987	Initial FY 1988	Account Surplus*	Exchange Rate	Oil Prices ($/barrel)
Banks					
Taiyo Kobe Bank	3.8%	4.2%	$75.0	Y130.5	$18.7
Tokai Bank	3.5	4.0	60.0	130	18.0
Yasuda Trust	3.9	4.0	78.5	130	18.2
Fuji Bank	3.8	3.7	78.0	125	17.5
Industrial Bank of Japan	3.8	3.6	81.3	130	19.4
Chuo Trust	3.6	3.5	69.0	129.8	18.5
Mitsui Trust	3.1	3.5	68.2	130.2	18.5
Mitsubishi Trust	3.5	3.5	60.2	130	19.0
Hokkaido Takushoku Bank	3.6	3.5	74.4	128.5	19.5
Dai-Ichi Kangyo Bank	3.3	3.2	73.5	127	19.5
Bank of Tokyo	3.3	3.2	65.7	133	19.5
Insurance Companies					
Sumitomo Life	3.6	3.8	85.7	130.3	19.2
Asahi Mutual Life	3.6	3.7	79.1	129.0	19.5
Meiji Mutual Life	3.7	3.7	71.8	125	18.0
Nippon Life	3.4	3.4	81.6	125.0	19.1
Research Organizations					
Research Institute of the National Economy	4.0	4.3	77.3	128	17.5
Daiwa Securities Research Institute	3.6	4.0	66.1	126.8	16.5
Yamaichi Research Institute	3.7	3.8	68.8	133	17.0
Japan Economic Research Center	3.9	3.7	75.0	124.4	18.9
Okasan Economic Research Insitute	3.9	3.7	77.0	130.0	19.0
Nomura Research Institute	3.9	3.6	75.1	123	17.0
Nikko Research Center	3.7	3.6	70.4	130.0	19.0
Cosmo Research Center	3.7	3.4	76.3	135.6	18.8
Kansai Economic Research Center	3.8	3.3	86.9	130.1	19.0
Mitsubishi Research Institute	3.6	3.2	84.5	123	18.7
Average Forecast	3.7	3.6	74.4	128.7	18.5

*In billions of dollars

A recession in the United States is a possibility. The leading economic indicators have declined for three months in a row, often a sign of approaching recession. But most economists are more optimistic, predicting inflation-adjusted growth in the 1 to 2 percent range for calendar 1988.

Growing earnings on overseas investments will be a factor boosting the current account surplus in dollar terms, but even with substantial growth beyond their $16 billion level in calendar 1987, these returns will not be large enough to offset the growth in imports, leading to a decline in the overall current account (see Table 6). The composition of merchandise exports will change, with components for assembly in overseas plants becoming more important. In yen terms, exports will decline while expanding in dollars, the difference reflecting the yen's recent appreciation.

Table 6: Japan's Trade and Current Account Balances

	Actual		Estimated		Projected
	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Dollars (billions)					
Current Account	$37.0	$55.0	$94.1	$82.0	$72.0
Trade	45.6	61.6	101.6	92.0	81.0
Yen (trillions)					
Current Account	Y9.0	Y12.1	Y15.1	Y11.5	Y9.6
Trade	11.1	13.5	16.2	12.9	10.8
Exports	40.9	39.8	33.8	32.2	32.1
Imports	29.8	26.2	17.5	19.3	21.3

Source: Bank of Japan and Economic Planning Agency

Other forecasts of the current account surplus in FY 1988 differ from the government's assumption of a $10 billion contraction to $72 billion. The Bank of Tokyo, Ltd. sees a decline to $66 billion, but Sanwa Bank, Ltd. expects the surplus to come in at $77 billion. All forecasters agree that the FY 1988 dollar-denominated surplus will still be much larger than in any 12-month period prior to FY 1986. At the same time, a declining current account surplus will be paired with a drop in the net long-term capital outflow, reflecting in part investors' caution about dollar-denominated assets but also an increasing capital inflow as foreign investors return to Tokyo financial markets.

Domestic Private Demand - Spurred by low interest rates, housing has been a strong spot in the Japanese economy, rising by almost 23 percent in calendar 1987. In the third quarter, private residential construction contributed almost one-third of the growth of real domestic demand. Growth may already have peaked, though, and few observers expect much further contribution, primarily because the new units were a response to accumulated demand. Sanwa Bank, in a typical forecast, sees a small drop in housing starts but a 1 percent gain in the real value of residential construction.

Easily the biggest part of Japanese domestic demand is consumer spending. Even small changes in personal consumption, which accounts for over half of GNP, can be decisive in determining the direction of the economy. The government's outlook clearly depends on this sector to carry a lot of weight in FY 1988 since both government spending and housing are expected to register slow growth.

There are reasons to expect a lift from this sector. Low interest rates on consumer loans should be a spur, and consumers benefit at least a little from the appreciating yen, which has helped keep inflation low. As export-oriented firms put new emphasis on the domestic market, consumers benefit from lower prices and new, attractive products. Moreover, government pump-priming measures taken in FY 1987 are expected to increasingly spill over into consumption in FY 1988. In addition to the tax cuts of late FY 1987, taxes will be cut by Y700 billion ($5.6 billion) in FY 1988. With inflation expected to continue at moderate levels and wage increases this spring expected to exceed last year's 3.6 percent, Nomura Research International is forecasting that consumption in real terms will grow by 3.6 percent.

A striking characteristic of Japanese growth in FY 1987 has been the depletion of inventories (see JEI Report No. 5B, February 5, 1988), a reverse of the situation in the United States where stocks have been accumulating. As U.S. producers work down their inventories, growth is likely to suffer. In Japan, rebuilding inventories to levels corresponding to expected levels of economic activity will be a major factor pulling up domestic demand. Nomura, for example, expects private inventory investment to contribute 0.3 percentage point to its overall estimate of 3.6 percent real GNP growth in FY 1988.

The brightest part of domestic demand, however, is widely anticipated to be private plant and equipment investment. Expected profits are an important factor in predicting capital spending, and manufacturing profits, which slumped almost 30 percent in FY 1986, are expected to increase substantially in both FY 1987 and FY 1988 (see Table 7). At the same time, earnings in the nonmanufacturing sector are predicted to drop, mainly because of rate cuts by public utilities passing on the benefits of lower energy prices.

Table 7: Corporate Profit Outlook

(year-to-year percent change, unconsolidated pretax profits)

	FY 1986 (actual)	FY 1987 (forecast)	FY 1988 (forecast)
Major Non-financial Firms (441 firms)	-7.4	+6.2	+13.5
Manufacturing Firms (323 firms)	-29.9	+51.4	n.a.
Nonmanufacturing Firms (118 firms)	+16.8	-23.2	n.a.

Source: Waco Research Institute of Economics

Nomura sees an 8.7 percent increase in real plant and equipment investment, but the Bank of Tokyo, which expects domestic capital spending to suffer as Japanese corporations invest abroad, puts the increase at 5.2 percent. A recent survey by the daily Nihon Keizai Shimbun showed that the polled 896 firms plan to increase investment by 5.8 percent, including a 13 percent jump by manufacturing firms.

Some Japanese analysts are worried that the predictions of increased consumer spending might turn out to be too optimistic while investment plans prove correct. If capital spending adds capacity, manufacturing firms might try to export the additional production if they cannot sell it at home, leading to new trade frictions.

Government Policies

The government was unable to get major tax reform in 1987, although some changes were made in the tax system (see JEI Reports No. 20A, May 22, 1987, and No. 30B, August 7, 1987). While Prime Minister Noboru Takeshita and others continue to talk about far-reaching tax reform, it may be postponed again. Even if some kind of measure is passed, it is likely to be revenue neutral and have little effect on the economy as a whole.

In 1987 the government took a larger role in stimulating domestic demand than it had originally intended, implementing measures that increased spending and reduced taxes. In the new fiscal year it plans to be less active, expanding real spending by only 1.7 percent. As a result, government spending will contribute only 0.3 percentage point to the forecast growth rate, far less than in the current and previous fiscal years. On the other hand, many economists assume that the government will have to revise its plans. Nomura, for example, is projecting a 4.6 percent increase in government spending in FY 1988, which means the government sector would contribute 0.6 percentage point to overall real growth.

In addition, the government will be worrying about the budget deficit, which it is eager to reduce, and inflation, which it hopes to avoid. Some government spending planned for January-March 1988 was put off until after April 1 in response to fears that prices of construction materials were rising. If the yen should resume its upward movement, the government could be forced to temporarily abandon its fight against inflation and red ink in favor of measures to keep the expansion going.

Monetary policy was particularly important for the Japanese government in calendar 1987. At the end of the year the money supply (M2 + CDs) stood 11.5 percent higher than in December 1986. For most of 1987 growth on a year-to-year basis was in double digits. The Bank of Japan is expected to gradually slow down the expansion but keep it above the real rate of growth of the economy for the foreseeable future.

Conclusion

Since early 1985 when the yen began its sustained rise against the dollar and many other currencies, the Japanese economy has been changing in dramatic ways. While the statistics sometimes appear contradictory, the broad

outlines are clear. Increasing domestic demand is more than offsetting a decline in real net exports to keep the economy growing. For the year that begins April 1, the best guess for inflation-adjusted GNP growth is around 3 percent. But given the fact that growth is occurring in the midst of a considerable transformation of the economy and in the context of hard-to-predict external forces, any predictions about the Japanese economy are far more uncertain than the close clustering of forecasts from different sources suggests.

Japan's high savings rate has been simultaneously financing a large budget deficit at home, part of the U.S. budget deficit, and capital spending by Japanese companies in Japan and abroad. An important question for the future is how rising consumption, which reduces savings, will be reconciled with new de- mands on those savings. A continuing large U.S. budget deficit, and the demand it generates for financing from Japan and elsewhere, would make the Japanese transition toward domestic consumption-led growth more difficult.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

Appendix: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	FY 1986	October-December 1986	January-March 1987	April-June 1987	July-September 1987
Gross National Product	Y293,903.6 (4.4%)	Y301,679.7 (2.6%)	Y302,299.0 (2.8%)	Y306,780.1 (6.1%)	Y306,805.8 (0.0%)	Y313,046.7 (8.4%)
Personal Consumption Spending	163,315.8 (2.8%)	169,195.1 (3.6%)	168,584.8 (-2.3%)	171,935.2 (8.2%)	173,089.9 (2.7%)	174,678.2 (3.7%)
Private Residential Construction	14,095.9 (2.9%)	15,637.9 (10.9%)	16,263.4 (22.6%)	16,459.1 (4.9%)	16,950.2 (12.5%)	18,696.9 (48.0%)
Private Fixed Nonresidential Investment	53,920.4 (13.2%)	56,361.2 (4.5%)	56,543.9 (7.3%)	57,949.6 (10.3%)	58,973.3 (7.3%)	60,292.3 (9.3%)
Change in Business Inventories	2,036.0 (*)	515.2 (*)	885.7 (*)	143.9 (*)	906.7 (*)	1,046.3 (*)
Government Current Expenditures	27,158.2 (1.6%)	29,002.0 (6.8%)	31,983.9 (70.9%)	28,384.9 (-38.0%)	28,726.6 (4.9%)	28,631.7 (-1.3%)
Government Fixed Investment	20,796.1 (-6.3%)	22,162.2 (6.6%)	22,262.1 (3.6%)	22,417.9 (2.8%)	22,797.4 (6.9%)	23,545.4 (13.8%)
Change in Government Inventories	297.8 (*)	816.0 (*)	-1,891.6 (*)	226.2 (*)	-102.2 (*)	-9.2 (*)
Net External Sector	12,283.4 (20.9%)	7,990.1 (-35.0%)	7,666.9 (13.5%)	9,263.3 (113.1%)	5,463.9 (-87.9%)	6,165.1 (62.1%)
Exports of Goods and Services and Factor Income Received	54,664.2 (2.1%)	52,689.5 (-3.6%)	52,147.6 (-2.3%)	53,451.0 (10.4%)	52,466.1 (-7.2%)	55,958.2 (29.4%)
Imports of Goods and Services and Factor Income Paid	42,380.8 (-2.3%)	44,699.5 (5.5%)	44,480.7 (-4.8%)	44,187.7 (-2.6%)	47,002.2 (28.0%)	49,793.1 (26.0%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency